

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:HOU:TL-N-5446-99 and 5447-99
LDBrigman

date: SEP 15 1999

to: Chief, Quality Measurement Staff, Houston District

from: District Counsel, Houston District, Houston

subject: Review of Proposed Notice of Deficiency

Taxpayer: [REDACTED]

SSN: [REDACTED]

Years: [REDACTED]

S/L: [REDACTED] for gift made on [REDACTED]

S/L: No date for gift made on [REDACTED]

Taxpayer: [REDACTED]

SSN: [REDACTED]

Years: [REDACTED]

S/L: [REDACTED] for gift made on [REDACTED]

S/L: No date for gift made on [REDACTED]

Statute of Limitations

The taxpayers, who are husband and wife, made two gifts at two separate times in [REDACTED]. They filed a joint return for the first gift and separate returns for the second gift. The gift tax returns for the two gifts were filed on the following dates:

Date of Gift

Date Return Received by I.R.S.

[REDACTED] gift: [REDACTED]

[REDACTED] gift: [REDACTED]

Under I.R.C. § 6019, one return for calendar year [REDACTED] was due [REDACTED]. The second return filed by the taxpayers is not an amendment of the first return. The dates of the gifts and amounts are different and the taxpayers have made no claim that the second is an amendment.

The tax reported on the first return is minimal and the proposed adjustment is around \$[REDACTED]. In contrast, the proposed tax adjustment on the second return is substantial, around \$[REDACTED].

10873

There is a three-year statute of limitations on assessment of the gift tax, specifically, three years after the return has been filed, or if timely, three years from the due date of the return. I.R.C. § 6501(a) and (b). For I.R.S. record keeping purposes, the statute of limitations date was calculated three years from the earliest return received date, or three years from [REDACTED]. Thus, our records indicate that [REDACTED] is the date on which the statute of limitations expires.

Because two gift tax returns were filed, the date from which the statute of limitations runs is not entirely clear. A good argument can be made that the starting date is [REDACTED], making [REDACTED] the statute of limitations date, at least for the second return.

However, the [REDACTED] filing does not adequately describe the gift. The [REDACTED] return describes the gift as follows:

[REDACTED]

Donors adjusted basis: \$ [REDACTED]
Date of gift: [REDACTED]
Value at date of gift \$ [REDACTED]

The three year limitations period in I.R.C. § 6501 applies to a "return required to be filed by the taxpayer." The question here is whether [REDACTED] provided sufficient information so their "return" is recognized as a valid return to start the statute of limitations running.

I.R.C. § 6001 authorizes the Secretary to prescribe regulations for filing gift tax returns. It states, "every person liable for any tax imposed by this title ... shall ... make such returns and comply with such rules and regulations as the Secretary may from time to time prescribe." I.R.C. § 6001. Regulations prescribing the information to be provided on gift tax returns are at Treas. Reg. § 25.6019-4.

The basic thrust of the regulations is to require sufficient information to readily identify the gift. "The properties comprising the gifts made during the calendar year ... must be listed on the return and described in a manner that they may be

readily identified." Treas. Reg. § 25.6019-4. These regulations are legislative regulations and therefore entitled to extra weight. True v. United States, 354 F.2d 323 (Ct. Cl. 1965).

In addition to the general requirement to describe the gift so that it is readily identified, the regulations require specific information for gifts of real estate, bonds, stocks, etc. For example, descriptions of gifts of stock must include "number of shares, whether common or preferred, and if preferred, what issue thereof, par value, quotation at which returned, exact name of corporation, and, if the stock is unlisted, the location of the principal business office, the State in which incorporated and the date of incorporation, or if the stock is listed, the principal exchange upon which sold." Treas. Reg. § 25.6019-4.

While no specifics are provided in the regulations for descriptions of partnership interests, the information pertinent to stock should provide guidance. At the very least, the description of the [REDACTED] gift should have provided number of units gifted, whether limited or general interests, exact name of partnership, address of partnership, State in which the partnership was formed, and date of formation. All of this information was readily available. It is discussed in the valuation report dated [REDACTED]. Note, the second gift tax return was filed [REDACTED], four month after the valuation report is dated.

In view of the lack of any information that readily identifies the gift, the question that arises is whether the taxpayers have filed an adequate return to start the running of the statute of limitations period. In our view, they have not, but only for the return received [REDACTED].

As previously stated, the taxpayers filed two returns for their [REDACTED] gifts where only one was required by the statute. I.R.C. § 6019. Does the first return filed [REDACTED] commence the statute of limitations? Probably not. Estate of Simpson, T.C. Memo. 1994-207, addressed an analogous factual situation. The taxpayer filed annual returns during the time period when quarterly returns were required (i.e., 1972 through 1981). The Commissioner took the position that the taxpayer's filings were not returns because they were not filed quarterly, as required by law in effect at that time. The Court ruled against the Commissioner. Taking a practical approach, the Court found that the filings, although they were for the wrong period, covered all of the taxable periods and provided the Commissioner all of the information necessary to calculate the liability of

the taxpayer for the periods in dispute. Thus, the filings were treated as proper returns by the Court. The Estate of Simpson Court noted that the Commissioner had not suggested that the taxpayer had attempted to evade their gift tax liability and that the Commissioner waited 16 years before taking action.

The [REDACTED] and [REDACTED] gift tax returns clearly do not fall within the type of facts presented in Estate of Simpson. Thus, the practical approach that the government had sufficient information, should not be applied. Due to the inadequate descriptions, all of the information required to identify the gift and calculate the gift tax is not present on the returns. Further, we should be in a position to close this case quickly, not wait 16 years. While no indicia of fraud are present, it is likely that significant indicia of tax planning verging on abuse can be developed.

Our analysis of the statute of limitations question is based largely on the taxpayers' failure to comply with the regulations. There is no case law holding that an unsatisfactory description in a gift tax return is the equivalent of no return. In fact, there is very little case law that even cites Treas. Reg. § 25.6019-4. It is mentioned in passing in Dickman v. Commissioner, 465 U.S. 330, 352 (1984) and in Karlin v. Commissioner, T.C. Memo. 1987-621, as one of many factors indicating that the taxpayer had not made a gift.

Despite the lack of precedent, we believe it is reasonable to assert that a faulty description constitutes an inadequate return in this case. Our options at this point are:

- (1) Accept the case as developed and issue the statutory notice of deficiency for both returns.
- (2) Close with case without issuing a notice.
- (3) Complete development before [REDACTED] and issue notice on [REDACTED] for only the second return.
- (4) Treat the case as though no return were filed, develop the case within a fairly short time period, and issue the notice for only the second return.

We suggest following option #3 and re-evaluating the situation on [REDACTED]. Specifically, issue summons for

the documents discussed below and interview [REDACTED]. The banks should be able to respond quickly. If possible, interview [REDACTED]. If responses from the summons are forthcoming, a statutory notice of deficiency can be issued on [REDACTED]. If not, I suggest we follow option #4 and interview all the interested parties in addition to issuing summons.

If it is decided that no further time should be devoted to this case, we suggest following option #2 because the file does not contain adequate factual support for a lack of economic substance argument. Lack of economic substance is an argument that the Office of Chief Counsel believes should be made in conjunction with I.R.C. § 2704 until we get favorable case law under § 2704.

I.R.C. § 2704 and Lack of Economic Substance

The reasoning behind the proposed adjustment is that the partnership has no economic substance for tax purposes and should be valued without regard to the restrictions on withdrawal and liquidation under I.R.C. § 2704. These reasons are generally applied in these sorts of family limited partnership cases, however, the facts to support lack of economic substance have not been developed.

Lack of economic substance is a judicially developed doctrine closely akin to the principle that the substance of a transaction prevails over its form. Cases involving the issue of substance over form require resolution of significant questions of fact. Those questions of facts have not been developed.

Essentially, the form of the [REDACTED] gifts has been developed, but not the substance. Lack of economic substance involves two parts: (1) the objective economic substance and (2) the subjective intent of the parties. See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231, 245-53 (3rd Cir. 1998), aff'd in part and rev'd in part, T.C. Memo. 1997-115, cert. denied, 119 S. Ct. 1251 (1999).

(1) The objective economic substance

Developing the facts to determine whether the partnership possesses objective economic substance, requires examining whether the formation and operation of the partnership resulted, as a practical matter, in a change in the taxpayers' economic position. This is, for the most part, a before and after

analysis.

Interview the taxpayers, if time permits, to find out who made decisions on management of the taxpayers' stocks and bonds before formation and, likewise after formation of [REDACTED]. How were those decisions made (e.g., after consultation with [REDACTED] or a broker or financial advisor.) Similarly, how did the business of [REDACTED] operate? What did [REDACTED] do? What did [REDACTED] do? What changes in the way they managed their asset result from formation of the partnership? Who signed proxies requested by management of their publicly traded stock before and after? Who decided whether to sign proxies? If the partnership borrowed money, who decided to make that decision. What factors were considered. Were management fees paid? Who decided whether to pay and what factors were considered? Did the partnership receive management fees? Why? From whom? Who keeps the books? Why was that person selected? What else does the bookkeeper do? What responsibilities did the bookkeeper have before the partnership was formed? Where was the interest and dividends from the stock and bonds deposited before and after? Who selected the partnership's bank?

Summons the following information from the appropriate party:

- Stock and bond transfer records substantiating the transfer to the partnership
- Pre-nuptial agreements or post-nuptial agreements, including the list of each spouse's separate property¹
- All financial statements of the partnership
- All reports or analyses prepared regarding the partnership operations
- Copies of bank statements, including checks

¹ These agreements are very important in this case. Given the facts, [REDACTED] could have entered into a pre-nuptial agreement. If [REDACTED] owns no interest in any of the assets transferred into the partnership, we may have an argument that we have a sham partnership. See Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989) and LaFarque v. Commissioner, T.C. Memo. 1985-630.

written on the partnership account and deposit slips.

- Copies of all account statements for the stock and bonds that are closest to the dates of the two gifts in question.²

- Copies of partnership minutes.

- Copies of the bookkeeping records of the partnership.

(2) The subjective intent of the parties

Developing subjective intent of the parties means finding out whether the taxpayers had any useful non-tax purpose for forming the partnership apart from the desire to obtain the tax benefits. Summons the appropriate party for the following:

- Notes from meetings discussing formation of the partnership.

- Engagement letter with the firm that was engaged to form the partnership, the firm's time slips, and billing statements.

- All correspondence between the taxpayer and the firm forming the partnership regarding creation of the partnership.

- all reports, analysis and computations prepared prior to formation of the partnership regarding the benefits of its creation.

- the taxpayer's financial statements shortly before creation of the partnership and shortly thereafter.

- copies of all powers of attorney granted by either taxpayer during the formation phase of the partnership.

- copies of all assignments of partnership interests.

- copies of all information furnished to the

² Our appraisers will need these statements for their valuation reports.

appraiser to enable him to prepare the appraisal.

If time permits before [REDACTED], interview the taxpayers to find out how [REDACTED]'s children from a prior marriage are affected by the decision to form the partnership. What benefits he and [REDACTED] were advised of? Who represented [REDACTED]? Have them describe the negotiations that they had on formation of the partnership. What particular terms are in the partnership agreement as a result of their negotiations? What was the origin of the assets that were transferred to the partnership and whose efforts created those assets? What assets did they keep out of the partnership? What did each spouse contribute to the partnership? What was the state of [REDACTED]'s health? Why could their assets no longer be managed as before? What are the business purposes for creation of the partnership? What factors did [REDACTED] consider in consenting to the restrictions that the partnership imposes on them? Why did they agree to those restrictions? Go over each restriction and have the taxpayers explain what it means, how it benefits them, and why it is in their agreement. Was the partnership appraised for any purposes other than gift tax? How was the particular appraiser used selected? Who selected him? Why?

The person who drafted the partnership agreement should be interviewed for the purpose of finding out if the partnership agreement was drafted specifically for [REDACTED] or whether it is part of a package sold to taxpayers. [REDACTED] appears to have drafted the agreement, however, he may have obtained it from another source, such as A financial planning group.

Find out if [REDACTED] paid another party any money in connection with his use of the package he provided to [REDACTED]. Attached is a redacted memorandum from the National Office to Deborah Delgado regarding a deposition of a financial planning group in connection with an upcoming trial. Apparently, a financial planning group wrote a standard agreement and other documents and marketed the package to attorneys as a gift and estate tax savings program. The attorneys then used the forms to prepare FLPs for their clients. You may not have time to pursue this avenue in this case, however, the information may be useful for other purposes. If your time is limited, summons [REDACTED] for the purpose of finding out (1) who sold him the package that he used for [REDACTED] (2) what was the business purpose for forming the partnership, and (3) the documents listed above that he should have in his files as the drafter of the

partnership agreement.

Recipients of the Notices

We suggest adding [REDACTED] name to the list of recipients as [REDACTED]'s attorney. Also, double check the address of the taxpayers. I searched the locator services on LEXIS and found a different current address for [REDACTED]: [REDACTED]
[REDACTED].

Language on Notice

The language needs to be revised to reflect only the gift tax return filed [REDACTED].

The \$ [REDACTED] exclusion should not be granted the taxpayers because the Trust and partnership provisions do not grant the donee a present interest in the gift.

Below is standard language that can be adapted for this case, assuming a factual basis is shown:

Alternatively, it is determined that there is no economic substance to the formation and operation of the [name of FLP], that the [name of FLP] lacked a business purpose, and that the [name of FLP] cannot be recognized for federal transfer tax purposes.

Alternatively, it is determined that in substance and effect the decedent's interest in the [name of FLP] is more analogous to an interest in a trust than to an interest in an operating business and should be valued as such for federal transfer tax purposes.

Alternatively, it is determined that any lapse of voting or liquidation rights in the [name of FLP] should be treated as a transfer by the decedent which is a taxable transfer pursuant to IRC § 2704(a).

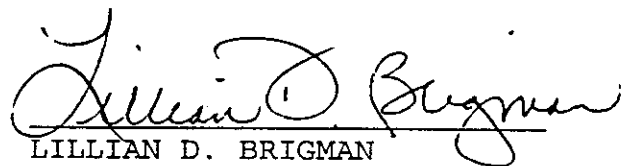
Alternatively, it is determined that certain restrictions on liquidation of the [name of FLP] interests contained in the partnership agreement should be disregarded for valuation purposes pursuant to IRC § 2704(b).

Alternatively, it is determined that the fair market value of a _____ percent limited partnership interest in the [name of FLP] is \$_____.

Please do not hesitate to call if there are any questions. My direct dial number is 281-721-7311. I would like to hear from the Estate & Gift Tax Attorney as to his progress shortly before [REDACTED]. District Counsel is prepared to defend our interpretation of the statute of limitations if development of the case needs to go beyond [REDACTED]. District Counsel does not need to review the statutory notice again, but we will assist if needed.

BERNARD B. NELSON
District Counsel

By:



LILLIAN D. BRIGMAN
Special Litigation
Assistant

Attachments